DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1519
San Diego, California

40 Letters per Year — $50.00 Annually

Registered with the Securities Exchange Commission

June 15, 1965 Letter 291

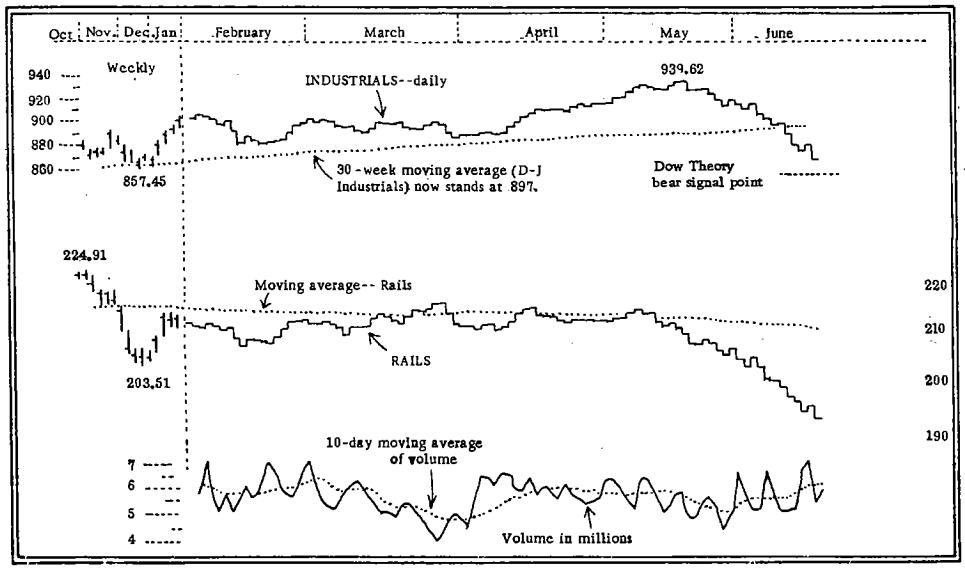
THE MARKET: It is probable that the 1962 crash represented the only purely "technical" market collapse of this century. There was little or nothing in the fundamentals during 1962 (such as a decline in leading business indicators or a downturn in bank credit statistics) to suggest that that year would witness the worst spring crash in market history. The 1962 debacle was unique, and there is not much else we can say about it. Following the 1962 crash, business continued its expansion, technicians gloated over their "success" in calling the turn (at least a few of them did) and market fundamentalists scratched their heads while doing their best to forget the whole episode.

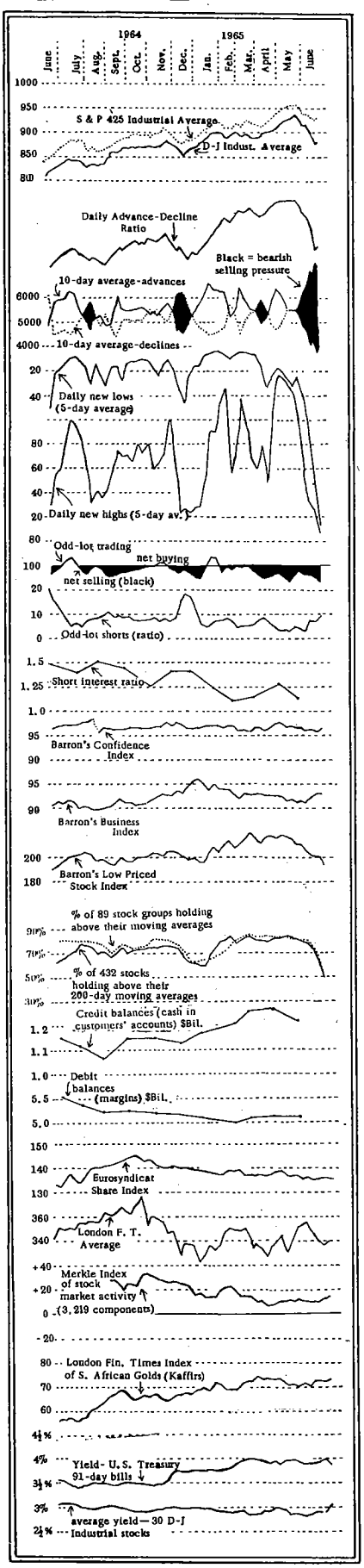
All of which brings us to the present. As I read and re-read the dozens of market letters and advisory services which arrived here last week, I noted the prevalence of one particular line of thinking: "The short and even the intermediate term picture may be bearish," state these reports, "but the long term trend is undoubtedly still bullish. There will be no major trouble until the end of this year or even until 1966."

Personally, I have never had any success with this type of "crystal ball" approach to the market. Moreover, I cannot remember a bear market (or a really severe secondary reaction) which was advertised as such in advance. But I do know that each bear market has its own built in "fooler," and I wonder whether the fooler next time (could it be happening now?) may not be clear danger signals in the fundamentals, danger signals which will provide very little help to the newly-formed army of Wall Street technicians. After all, a handful of technicians were the heroes of 1962, and Wall Street has a nasty way of "burying" its last year's heroes. If the current decline is fated to be the beginning of the end, only the Rails (as interpreted in terms of Dow Theory) suggested the trouble from the technical standpoint. Make no mistake about it, the great majority of technicians are still insisting that there will be no major bear market at this juncture ("too few recognizable tops in individual stocks, the public never came in during 1963 and 1964, the short position is still too large, odd-lotters have not yet switched to the buy side, etc."). Technicians who have not received their "official sell signals" may ultimately prove to have been right — but I am not about to bet my bank roll on it.

It bothers me at this time that there are a number of disconcerting fundamental factors in the picture, not the least of which is the mountainous debt structure in this nation, the collapsing commodity markets, the sharp decline in the momentum of many bank credit figures, the sky-rocketing turnover in demand deposits in New York, the declining debit-loan ratio.

All in all, I prefer to pin my hopes on the Dow Theory, which, although far from perfect,




1964
1965
S & P 425 Industrial Average
D-J Indust. Average
Daily Advance-Decline Ratio
Black = bearish selling pressure
10-day average-advances
10-day average-declines
Daily new lows (5-day average)
Daily new highs (5-day av.)
Odd-lot trading
net buying
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low Priced Stock Index
% of 89 stock groups holding above their moving averages
% of 432 stocks holding above their 200-day moving averages
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London F. T. Average
Merkle Index of stock market activity (3,219 components)
London Fin. Times Index of S. African Golds (Kaffirs)
Yield- U.S. Treasury 91-day bills
average yield—30 D-J Industrial stocks

 has been right many more times than it has been wrong. The Dow Theory has kept me skeptical about the advance ever since the Rail Average "topped out" in October, 1964. The Dow Theory provided me with the urge to "clean house" during May and June when the Rail structure began breaking down in earnest. Finally, I am now watching the 857.45 Industrial level in order to determine whether the great primary trend of the market has turned from bull to bear or whether this is nothing more than a violent secondary reaction within a continuing primary bull trend (from the standpoint of Dow's Theory, as long as Industrials hold above the December low of 857.45 the primary trend is taken to remain bullish).

Many investors are calling this "the Martin decline" in honor of our Reserve Board Chairman and his recent "1929 comparisons" speech. But this is absurd on the face of it, and those of us who have spent even a few minutes a day studying the market know that potential trouble has been brewing ever since Rails turned down last October. Mr. Johnson and his aides have already leaped into the breech and in a June 10 press conference Johnson forecast "solid but moderate" gains for the rest of 1965. If a rally starts we can therefore take the liberty of labeling it "the Administration retracement."

The decline has now erased 12% from the Rail Average, taking that Average to the 196 area. In doing so, Rails have dropped to a thirteen month low. Since their May peak of 939.62, Industrials have lost a little better than 7%, but the senior Average is (at this writing) still well above the critical 857.45. In the event of an actual bear signal, many neophytes will claim that "the signal came too late." But following a two year advance in an ancient bull market and following seven consecutive months of divergence in the Averages, there was ample reason to play it safe and abandon ship. Frankly, I do not know of a single knowledgeable Dow Theorist who has been hurt by the current decline. Most of us have been happy enough to pay "the cost of insurance," and this means unloading well before a potential bear signal in an ageing bull market.

On Tuesday (June 8) the Industrial Average plunged below its 30-week moving average (Chart 1) which now stands at 896. This was the first penetration of the M.A. since November, 1963 (the Kennedy assassination panic), but whereas the assassination penetration lasted only a single day (to be followed by an immediate rally), this penetration appears to "mean business." On June 9 the Industrials closed below their February low of 881.88 on heavy volume of 7 million shares. Thus the two danger points this side of an actual bear signal, the moving average level of 896 and the 881.88 February level, have both been violated (see Letter 290, Page 1). After an unimpressive rally on Friday (June 11), the decline was resumed on Monday. This writer could not decide whether the Monday Wall Street Journal headline ("Price Slide Is Slight Gauged by Standards of Past Major Declines") was calculated to arouse hopes or fears. Conclusion: The minor and secondary trends are bearish. The primary trend will be classified as bullish as long as Industrials close above 857.45.

The Composite (Page 1) Chart shows both major industrial averages moving sharply lower with the advance-decline leading on the downside and now less than half a point from its December low. The 10-day average of daily declines is now showing more selling pressure than any time since 1962 and by "ordinary" measurements the market is getting oversold. But just as the market can stay overbought during major advances, the market can stay oversold during important declines (the black or "selling pressure" area predominated for 70 trading days during 1962). Daily new highs (5-day av.) have now dropped to 6, lowest level since October, 1962, while daily new lows have risen to 174 — most since October, 1962. Odd-lotters continue selling but the peculiar reticence of the odd-lot shorts to come in (see later section) presents a negative picture at this time. The percentage of 89 stock groups holding above their moving average has dropped sharply to 44, thus turning this important indicator bearish. The percentage of 432 stocks holding above their M.A.'s has also dropped slightly below 50%, and this confirms the bearish picture. The Eurosyndicat Index is at a new low of 136. The writer keeps price charts of 7 leading foreign exchanges and momentum indexes on each (i.e., price of each as a ratio of its price one year ago). All of the 7 are now declining in momentum with 6 of the 7 momentum figures in the minus column (meaning that these averages are below their actual prices of one year ago). Last week Austria, Belgium, Canada, France, Holland, Switzerland and West Germany closed at or very near their lows for 1965. This is a very serious picture and suggests a possible primary (rather than secondary) decline. The S. African golds closed the week at 72.5, less than 2 points from their 4-year high of 74 set in March. As older subscribers know, the S. African golds have been the only group that I have continuously recommended for purchase. Conclusion: The most sanguine thing one can say about this market is that an orthodox bear signal has not yet been given. As long as the D-J Industrial Average holds 857.45, then (regardless of our own personal bearish "feelings" or inferences), the primary trend will be taken to remain bullish.

Question: Do you think we could now be seeing the beginning of the bear market, the bear market which is fated ultimately to correct the entire bull market which began on June 14, 1949, at 161.60 on the Industrial Average and 41.03 on Rails? Answer: I believe the odds are better than 50/50 that we could now be seeing the early stages of the breakup of the post-war boom. The 1921-29 bull market started at 64.90 on the Dow. It ended 8 years later with the Dow up 488%. The 1949 bull market started at 161.60 on the Dow. Now, 16 years later, the Dow is up 483%. Even allowing for a possible summer rise to new highs in the Industrial Average (probably unconfirmed by Rails), I believe that history may well record October 20, 1964 (the date of last confirmed highs on both Averages) as the true top.

Question: If Industrials break the 857.45 level, thereby rendering an actual bear signal, what sort of action would you expect to see? Answer: Again, I am guessing, but judging by the early violence of this decline so far, if the bear signal is given I would expect huge downside volume (perhaps over 10 million shares), and I would expect the panic phase of the decline to set in. This is the stage, often characterized by a crash, in which stocks are thrown in "at the market" as the public and large interests see their profits evaporating and their losses starting to grow.

Question: Do you expect a profitable buying spot at some point ahead? Answer: Yes, I do. No one ever knows how successful a buying spot has been until well after the recovery, but as a rule the worse the decline and the greater the "compression" on the downside, the greater the ultimate recovery. The violent 1929 crash was followed by what was probably the most explosive bear market rally in history — the rally into April, 1930. The disastrous 1937 bear market crash ended in March, 1938, and it was followed by the extraordinary rise into November, 1938. The March-November, 1938, advance, by the way, added better than 50% to the price of the

Industrial Average! Following the current decline, which shows much eveidence of violence, I would expect a substantial and profitable recovery. It is of some comfort to those investors who are now in cash to know that the worse the decline, the safer the ultimate buy-spot and the greater the recovery potential.

Question: The decline in the Industrial Average since the May record peak of 939.62 has taken the form of a single, uncorrected drop. Would you expect the Industrials to terminate their decline with such a straight line plunge? Answer: This is a very difficult question. The great majority of important secondaries and bear markets have taken the form of at least two downward legs separated by one upward correction. Therefore, although this decline could conceivably terminate at any time, I would think it more likely that there will be at least one rally followed by a second Industrial leg down.

Question: What is the main danger here for the trader and investor? Answer: The great danger is that we may be in a primary bear market. We should remember that primary movements are a law unto themselves. Their duration and extent can not be predicted in advance. If, for the sake of argument, this is a primary bear market it could (and probably will) go much further than anybody suspects.

Question: What are some of the signs which would suggest that the current decline is nearing its end? Answer: One thing to look for is a large volume selling climax, a subsequent rally in both Averages, and then a second less violent decline (usually ending below the selling climax lows) on considerably less volume. Often there will be a final non-confirmation at the bottom.

Question: What about odd-lot shorts? (OLS). Answer: OLS should be watched very closely now. The OLS is the most speculative minded fellow in the market. As a rule, the OLS tends to be wrong on the trend — but most wrong at or near the end of a trend. In other words, the OLS is usually inactive near the top of an advance (when they "should" be most active) and very active near the end of a drop (when they should be least active). The OLS usually needs encouragement in the form of dropping prices before they will short the market. For this reason, OLS provides an extremely useful indicator during important declines.

It is well to note that at last year's mild May-June dip, the OLS rose to 12,000 on one day; there were also a few days of 8,000 OLS. Again during the December decline OLS pushed to above 8,000 for a few days. But on the current decline, OLS seem wary of shorting. On June 9, on a 9-point decline day following a long series of bad days OLS came forth with only 5,300 shorts. On June 10 we saw 7,000 shorts, a bit better. But on June 11 OLS quickly faded to 4,600 again. I would guess that we could see a few days with better than 10 to 12 thousand OLS before this decline terminates.

Question: (For our many new readers) On May 10 President Johnson said that the Administration sees nothing to suggest trouble ahead. Another Administration official stated that the current market decline is actually healthful. Will the Administration allow a decline of this severity to continue? Answer: If this is a bear market it will go to completion, and all that President Johnson, the Federal Reserve Board and anybody else can say will not put a dent in it. If it is still a bull market, then words and acts will — in time — help it along. As far as what President Johnson sees ahead, we had best adhere to the Dow Theory principle that the Averages see further ahead than any man or group of men.

Question: Often the Industrials trace out a "double top" prior to a major decline (as per 1937, 1956-57 and 1959). What do you think of the chance of such a performance today? Answer: A classic double top would provide a good vehicle by which traders and investors could exit from the market. Here again is my guess. If we get a full upward correction of this decline (the much talked about "summer rally") without Industrials first penetrating the 857.45 level (in other words, without a bear signal) then I believe that there is a fair chance of a retracement to or near the May 939.62 peak. However, if we get a bear signal (a penetration of the 857.45 level by Industrials), I would doubt that the eventual retracement will get much above the 900 level.

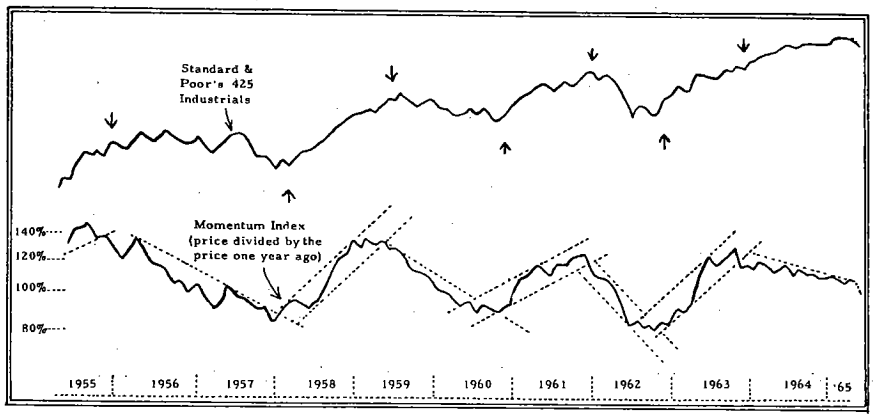
Question: As a conscientious market observer over the years, is there anything that particularly "bothers" you about the character of this decline? Answer: Yes, what bothers me is that almost everything seems to be going down together. The averages, the market breadth, foreign markets, commodities, bonds. If this continues, it will be the first time that this generation has seen a general deflation in all markets simultaneously.

A TEST: I often apply a simple but extremely helpful test to the market to determine whether the bull or the bear forces are in command. During a true bull trend, the market invariably produces numerous days which, for want of a better expression, I term "good days." What is a good day? A good day is one in which (1) all three Averages, Industrials, Rails and Utilities, rise together, and this includes both the Dow Jones and the Standard & Poor's Averages. A good day (2) is accompanied by expanding volume (compared with the preceding day), (3) more advances than declines, and (4) more daily new highs than lows — with new highs generally expanding over the previous day's new highs. This type of bullish performance is often seen day after day during strong upward trends, but it is seldom seen (even during violent rallies) within a major bear trend. A typical bear rally day may produce divergence in the Averages (Industrials advancing with perhaps Rails or Utilities or both going down) or perhaps volume will contract or new highs may shrink.

Just as a true bull movement will produce good days, a strong bear trend will produce many of what I term "bad days." These are days in which all three Averages decline (D-J and S & P), volume expands, daily new highs surpass new lows and declines outnumber advances.

The appearance of a single good day on the rally following a long decline is often a sign than an important reversal is occurring, and the converse may be the case when, after a long advance, a single bad day appears. I suggest that subscribers watch for this type of action — the production of these good or bad days. The rough rule is that good days only appear within continuing bull trends and bad days only occur within continuing bear trends.

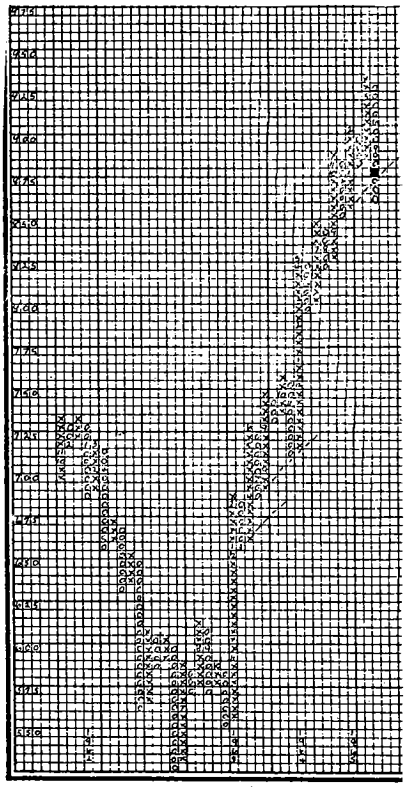
MOMENTUM INDEX (M.I.) A monthly report: This index (see chart) is merely the ratio of the price of the broad Standard & Poor 425 Industrial Average at the end of each month compared to the price of this index one year ago. If the Index is above 100, it means that this year's price is above last year's price, but it is the trend of the ratio which is important. If the M.I. is in a downtrend, it means that the market's momentum is ebbing (regardless of whether the market is higher or lower than last year).



As seen on the chart, the M.I. as of the end of May registered 109.9 which served to keep the Index within the downward channel. The rising 1962-63 channel was penetrated on the downside in November, 1963, and this means that the market has been losing momentum for the past 19 months. Up to this month the loss of momentum has been quite gradual (compared to say 1956-57 or 1961-62 — see chart). But the M.I. may now be starting a more rapid descent. Although the month of June is not yet over, computing the M.I. based on the June 11 S & P 425 closing of 89.88 shows the Index (compared with the same day in June, 1964) dropping to about 104. This would be a sharp new low, and I have shown it on the chart by the dotted line (actually, I will still wait for the end of June figures before finally plotting them in). All in all, the trend of the M.I. continues bearish.

THE DOW: As a point of interest, I include (courtesy of Chartcraft, Larchmont, New York) a point & figure chart of the Dow. This chart shows all movements of 15 points or more and each box equals 5 points. X's are advances, O's are declines. Note that the Dow gave its first "sell signal" when it broke its previous bottom and touched 880 (black square on chart). Note also that for the first time since 1962, the decline has dropped below a rising trendline formed by the previous decline. The chart implies that there should be a large supply of stock in the 880 level.

DOW-JONES INDUSTRIAL AVERAGE



STOCKS: I have written extensively about relative strength (RS) or the performance of individual groups and stocks compared with the general market. RS is of greatest use during important declines. Stocks that consistently outperform in a declining market (even though these stocks may actually be declining themselves) are often the leaders on the next important advance. I have just combed the Traders Research (P.O. Box 2644, St. Louis 16, Mo.) chart book for outstanding RS performances. This book is up-to-date (weekly), and although RS trends may change, the following groups and stocks stand out on the decline so far. Each of the stocks listed shows an established uptrend in RS. In a few instances, I eliminated stocks with favorable RS lines because they were situated in groups with poor RS. Generally, whatever factors affect a group unfavorably will eventually affect a stock in that group unfavorably (thus, for instance, Chicago Northwestern acts beautifully in a very poor rail group).

Three groups with favorable RS lines are Aircraft, Aluminum and Electronics. The following stocks show favorable RS trends and should be expected to be leaders on any reversal to the upside. This is not an immediate buy recommendation: we will watch these stocks until the market looks ready for trading on the upside. Aluminum Co. of Amer., Reynolds Metals, Lockheed, Northrup, National Cash Register, AMP Inc., Varian, Electronic Specialty, General Instrument, Texas Instrument, American South African, Dresser Industries, Macy, Spiegel, American Tobacco. I would not buy less than five different issues for trading purposes (odd-lots are perfectly all right in cases where capital is limited).

The above discussion applies to the intermediate term and in no way negates the discussion of "discounted puts" in the last Letter. Puts are obviously far too expensive when the market is dropping rapidly. Subscribers should work on discounted one-year puts when the next rally is well underway.

A final stock comment. Of the 30 DJI stocks, 17 are now bearish. The following 13 Dow stocks are still bullish, but the number in parentheses after each stock is the level which, if touched (even inter-day) will turn that stock bearish. Alcoa (65), Amer. Can (42), Amer. Tob. (31), Beth. Steel (34), Goodyear (44), Int. Nickel (78), Johns Manville (52), Owens-Illinois (50), Sears (63), Texaco (72), United Aircraft (67), Westinghouse (40), Woolworth (25). When the turn comes many veterans prefer to buy the five strongest among the still bullish Dow stocks. At present these are Alcoa, Amer. Tob., Goodyear, Int. Nickel, Woolworth.

As this is written (late morning Tuesday, June 15) the market is lower and Industrials are 7 points this side of a bear signal. The time is past for words .....